

BEFORE THE
POSTAL REGULATORY COMMISSION

Periodic Reporting
(UPS Proposals One, Two, and Three)

:
:
: Docket No. RM2016-2

UNITED PARCEL SERVICE, INC.'S RESPONSE TO
CHAIRMAN'S INFORMATION REQUEST NO. 1

United Parcel Service, Inc. ("UPS") respectfully submits the following response to the questions posed by the Commission to UPS in Chairman's Information Request No. 1 (November 20, 2015).

1. **UPS states that "[f]rom telecommunications and airports to electrical power and water utilities, public utilities have an economic incentive to leverage their governmentally-conferred monopoly power by expanding into competitive markets." Petition at 2.**

- a. **Please confirm that, unlike a majority of the public utility examples cited above, the Postal Service is not investor-owned;**

Confirmed, in part. UPS agrees that the Postal Service is not investor-owned, but disagrees that the majority of the public utility examples cited in its Petition are investor-owned utilities.

Examples of governmental monopoly utilities abound, including municipal electric¹ and gas² companies, municipal and regional water utilities,³ and even at the

¹ Based on statistics compiled by the American Public Power Association, less than 6% of electricity providers in the United States are investor-owned utilities, whereas over 60% are public (*i.e.*, government) power entities. See American Public Power Association, *2015-2016 Annual Directory and Statistical Report*,

federal level, federal power marketing administrations that are *de facto* monopoly providers for the electrical output of federally owned and operated hydroelectric dams in 33 states.⁴ Competition between such government enterprises and privately owned firms raises many of the same issues of costing and fair competition that the Postal Service's aggressive expansion into competitive markets raises today, as discussed in UPS's Petition.⁵

<http://www.publicpower.org/files/PDFs/USElectricUtilityIndustryStatistics.pdf> (last visited Nov. 30, 2015).

² In response to a 2006 survey of natural gas utilities conducted by the U.S. Energy Information Administration, 931 firms (71%) classified themselves as municipal entities, 257 (20%) as investor-owned, 104 (8%) as privately-owned, and 15 (1%) as cooperatives. See Energy Information Administration, Office of Oil and Gas, *Distribution of Natural Gas: The Final Step in the Transmission Process* at 3 (Jun. 2008), http://www.eia.gov/pub/oil_gas/natural_gas/feature_articles/2008/ldc2008/ldc2008.pdf.

³ According to a report from the National Association of Water Companies, more than 80% of the water utility market share is controlled by governmental entities (e.g., municipal water utilities, water boards and water districts). See National Association of Water Companies, *Water Policy Forum for State Public Utility Commissioners: Summary Report* at 7 (Apr. 2014), <http://www.nawc.org/uploads/documents-and-publications/documents/WPF%202014.pdf>; National Association of Water Companies, *The Truth About Private Water Service Providers* at 1 (2010), http://www.nawc.org/uploads/documents-and-publications/documents/document_9f2bbfe0-e863-4081-991f-0a3cc72b406d.pdf.

⁴ The four federal power marketing administrations are Bonneville Power Administration, Western Area Power Administration, Southwestern Power Administration and Southeastern Power Administration. See U.S. Energy Information Administration, *Federal Power Marketing Administrations Operate Across Much of the United States* (Jun. 12, 2013), <https://www.eia.gov/todayinenergy/detail.cfm?id=11651>.

⁵ See, e.g., R. Richard Geddes, *Competing with the Government: Anticompetitive Behavior and Public Enterprises* 27-58 (2004), available at http://www.hoover.org/sites/default/files/uploads/documents/081793992X_27.pdf (noting that “competition between state-owned enterprises . . . and privately owned, unsubsidized firms . . . has occurred in the provision of electricity, water, financial services, postal services, weather forecasting, information, freight transport, [and] mortgage lending,” and in each of these sectors “SOEs [state-owned enterprises] will expand their revenue base by venturing into new, competitive business lines . . .”).

- b. **If confirmed, please explain whether the incentive to expand into competitive markets applies to the Postal Service;**
- c. **If not confirmed, please explain why the Postal Service is similarly situated to the public utilities cited above.**

In some respects, the incentive for government monopolies to expand into competitive markets is no different from that of investor-owned utilities: a utility can leverage its monopoly position in one market to enter a competitive market, artificially lowering its costs in the competitive market through subsidies from its captive monopoly customers. By charging artificially low prices in the competitive market, the utility can expand its market share by undercutting private competitors. In turn, the larger market share enables the utility to better leverage economies of scale and scope, increasing its scale and further harming its now handicapped rivals.

Investor-owned utilities are generally driven by the pursuit of profit. In contrast, a state-owned enterprise like the Postal Service may be incentivized to expand its scale even when expansion would be unprofitable. That incentive to expand scale can derive from policy objectives, such as reaching national employment goals, or from the incentive to increase the enterprise's influence over national policy. Empirical research indicates that government managers may seek to expand the scale of their enterprise to realize the power and prestige that often accompanies expanded operations.⁶ Notably, the Postal Service's incentive compensation plan rewards managers with bonuses that are tied to measures of *scale*, including deliveries per hour and total revenue.⁷

⁶ See, e.g., Andre Blais & Stephane Dion, *Conclusion: Are Bureaucrats Budget Maximizers*, IN THE BUDGET-MAXIMIZING BUREAUCRAT: APPRAISALS AND EVIDENCE 355 (1991); David E.M. Sappington & J. Gregory Sidak, *Competition Law for State-Owned Enterprises*, 71 ANTITRUST L.J. 479, 500 (2003)

⁷ See Jeffrey C. Williamson, U.S. Postal Service, *Fiscal Year 2014 Pay for Performance Program* at 4 (Sep. 30, 2013), available at <http://www.napus.org/wp->

In pursuit of greater scale in competitive markets, the Postal Service, like other state-owned enterprises, has incentives to engage in unfair competition, including by understating costs, setting prices below cost, and engaging in other practices that leverage its government monopoly.⁸ By understating its costs for competitive products, the Postal Service can evade regulatory pricing constraints and charge artificially low and even below-cost prices.⁹ The recent Commission-sponsored study by Richard Cohen and John Waller, for example, acknowledged that the Postal Service has the incentive to minimize cost-attribution to maximize its pricing flexibility in competitive markets.¹⁰ The Postal Service also has the incentive to erect barriers to entry in competitive markets as a means to expand its scale and scope of operation beyond the point of profit maximization.¹¹

In light of today's economic realities, the Postal Service has a specific incentive to expand its scale by charging prices for competitive products below levels that efficient private competitors can meet. This is, in fact, likely the Postal Service's most realistic option for expanding scale given the falling demand for letter mail since the widespread adoption of email and electronic billing.¹²

content/uploads/2013/09/PFP-Prog-FY-2014-31.pdf; U.S. Government Accountability Office, *U.S. Postal Service: New Delivery Performance Measure Could Enhance Managers' Pay for Performance Program* (Sept. 10, 2008), available at <http://www.gao.gov/products/GAO-08-996>.

⁸ See Sappington & Sidak, *supra* note 6, at 480.

⁹ See, e.g., J. Gregory Sidak & Daniel Spulber, *PROTECTING COMPETITION FROM THE POSTAL MONOPOLY* 93 (AEI Press 1996).

¹⁰ See Robert Cohen & John Waller, *The Postal Service Variability Ratio and Some Implications* at 1 (2014).

¹¹ See Sappington & Sidak, *supra* note 6, at 480.

¹² See Sidak & Spulber, *supra* note 9, at 94.

Congress recognized that the Postal Service would be naturally tempted to engage in unfair competition in competitive parcel markets, and it further recognized that such unfair competition would, in the long run, distort those markets in undesirable ways. That is precisely why it enacted the safeguards of 39 U.S.C. § 3633. Congress understood that vigilance was required to prevent such unfair competition and thus requires the Postal Service to demonstrate on an ongoing basis that its competitive products are covering all costs reasonably attributable to them, individually and as a group. As UPS's Petition shows, however, they do not bear those costs today.

2. **UPS states that “[w]hile captive mailers are paying significantly increased prices and experiencing reduced service standards, the Postal Service is slashing prices of its competing products to drive up its market share.” *Id.* at 5.**

a. **Please confirm that the UPS position is that the Postal Service, by “slashing prices” on its competitive products, has been able to increase prices for captive mailers and to reduce service standards;**

Not confirmed.

b. **If confirmed, please reconcile these statements with the CPI-based price cap for market dominant products;**

N/A.¹³

c. **If not confirmed, please explain the meaning of the quoted text;**

UPS does not take the position that, by slashing prices on its competitive products, the Postal Service has been able to increase prices for captive mailers and

¹³ The CPI-based cap on price increases for market dominant products does not necessarily preclude the Postal Service from overcharging for those products. If the initial prices were too high, for example, the CPI-based cap would allow the Postal Service to charge prices that were higher yet. In addition, even if the Postal Service did not initially overcharge for its market dominant products, changing market conditions might warrant a price *reduction*, which the CPI-based cap would not necessarily require.

reduce service standards. Rather, to the extent there is a causal relationship between low prices for competitive products and high prices and reduced service standards for market dominant products, it flows in the opposite direction: the Postal Service is charging higher prices to captive mailers, while reducing service standards, in order to help fund its aggressive expansion into competitive product markets.

The Postal Service's competitive products business does not stand on its own financial footing. Instead, as demonstrated in UPS's Petition, the Postal Service is aggressively expanding in competitive markets on the backs of its captive mail customers. It is doing this, for example, by attributing to competitive products only the *marginal* cost of delivery, instead of attributing to them *all* of the variable costs they are responsible for (including the more expensive *inframarginal* costs). By attributing only marginal costs to competitive products, the Postal Service is able to set prices for competitive products based on the false assumption that the cost of *each* unit of its competitive products is equivalent to the cost of the *last* unit of production. Using this accounting fiction requires market dominant mailers to bear the great bulk of the other variable costs the Postal Service ignores when it sets prices for competitive products (*i.e.*, *inframarginal* costs).

This state of affairs is precisely what Congress intended to prevent when it passed the Postal Accountability and Enhancement Act of 2006 ("PAEA"). Congress granted the Postal Service greater freedom to price its competitive products on the express condition that those products would generate enough revenue to stand on their own financial footing.

Instead of making sure that occurs, the Postal Service has increasingly sought to impose reduced service standards and higher rates on market dominant mailers. The Postal Service has, for example, repeatedly attempted to raise rates on market dominant mailers above the rate cap. The Postal Service has been before the Commission four times seeking an exigent rate increase, and it is now on its third trip to the United States Court of Appeals for the District of Columbia Circuit after the Commission rejected its full demands.¹⁴

The Postal Service has also reduced service standards such that captive mailers now receive a lesser degree of service and timeliness for the same rates. See Commissioner Ruth Goldway, *Postal Service Cuts Ill-Considered*, THE HILL (Jan. 13, 2015), <http://thehill.com/blogs/congress-blog/economy-budget/229239-postal-service-cuts-ill-considered> (describing the degradation of service and timeliness of market dominant services). As quality of service decreases, quality-adjusted prices increase,

¹⁴ The Postal Service filed its first exigent rate request in 2010, Dkt. No. R2010-4, Exigent Request of the U.S. Postal Service (Jul. 6, 2010). The Commission denied the request, Order No. 547, and the D.C. Circuit affirmed the denial but remanded to the Commission to resolve a textual ambiguity. *United States Postal Service v. Postal Regulatory Comm'n*, 640 F.3d 1263, 1267 (D.C. Cir. 2011). The Commission resolved that ambiguity in Order No. 864. Dkt. No. R2010-4R (Sep. 20, 2011). Two years later, the Postal Service tried again. Dkt. No. R2013-11, Renewed Exigent Request of the U.S. Postal Service (Sept. 26, 2013). After the Commission granted the Postal Service request in part to the tune of \$2.8 billion, Dkt. No. R2013-11, Order No. 1926 (Dec. 24, 2013), the Postal Service again appealed the decision to the D.C. Circuit. The D.C. Circuit in *Alliance of Nonprofit Mailers v. Postal Regulatory Commission*, 790 F.3d 186, 193 (D.C. Cir. 2015), upheld “most of Order 1926,” but remanded to the Commission its determination that “lost mail volume can only be counted for one year.” *Id.* In Order No. 2623, the Commission approved under a new methodology another \$1.2 billion in exigent rate relief for the Postal Service. The Postal Service again appealed to the D.C. Circuit, and proceedings are currently ongoing before the D.C. Circuit. The Postal Service has also attempted to implement mail requirements which, if not complied with, would raise rates above the rate cap. See Dkt. No. R2013-10, Order No. 1890 (Nov. 21, 2013), *affirmed in part in U.S. Postal Serv. v. Postal Regulatory Comm'n*, 785 F.3d 740, 743 (D.C. Cir. 2015).

even as stated prices nominally remain constant. A monopolist that is constrained by a price cap can increase its per-unit profit by decreasing the quality of its product (and thereby decreasing its production costs) without increasing the product's price.

- d. **Please provide all evidence demonstrating that an increase in the Postal Service's market share in parcel markets, vis-a-vis its competitors, is attributable to the Postal Service lowering prices for competitive products.**

The Postal Service's current cost attribution practices are leading to the very market distortions that Congress sought to prevent in enacting 39 U.S.C. § 3633. Because its current costing models allow the Postal Service to set prices for competitive products that do not reflect the full scope of costs attributable to those products, the Postal Service is able to set artificially low prices in order to gain market share at the expense of fair competition and private competitors.¹⁵

In a separate docket, the Public Representative has noted that the Postal Service's recently announced rate increases for competitive products strongly indicate that the prevailing prices of many Postal Service competitive products are (and have been) too low, despite facially satisfying the currently applicable costing models:

[T]he most reasonable explanation for why the Postal Service can increase prices by the proposed amounts is that the current prices are set too low, despite meeting the applicable regulatory standards. Consequently, the Public Representative questions the accuracy of the accepted

¹⁵ That (quality-adjusted) prices affect market outcomes is a fundamental tenet of industrial organization and the economic analysis of antitrust and regulatory law. See, e.g., Dennis W. Carlton & Jeffrey M. Perloff, *MODERN INDUSTRIAL ORGANIZATION* 336 (Denise Clinton ed., 4th ed. 2005); Robert J. Gordon & Zvi Griliches, *Quality Change & New Products*, 87 AM. ECON. REV. 84 (1997); Jerry Hausman, *Sources of Bias and Solutions to Bias in the Consumer Price Index*, 17 J. ECON. PERSP. 23 (2003); Thomas W. Hazlett, *Prices and Outputs Under Cable TV Reregulation*, 12 J. REG. ECON. 173 (1997); Amil Petrin, *Quantifying the Benefits of New Products: The Case of the Minivan*, 110 J. POL. ECON. 705 (2002).

costing methodology to set a reasonable price floor. *It seems likely that the accepted methodology does not attribute all appropriate costs to competitive products.* Likewise, the minimum contribution requirement for competitive products collectively (5.5 percent to the Postal Service's institutional costs) may be set too low, which allows competitive products to be priced lower, and earn less, without violating current Commission's rules.

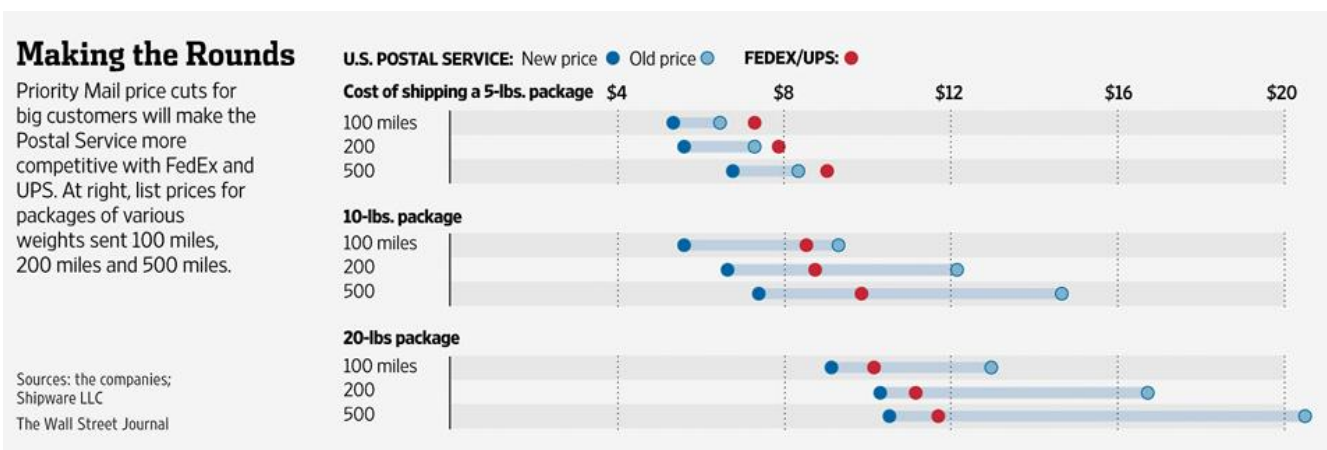
Dkt. No. CP2016-9, Public Representative Comments at 5 (Nov. 3, 2015)

(emphasis added).

UPS agrees that the current costing methodology does not attribute all appropriate costs to competitive products and that the minimum contribution requirement for competitive products collectively is set too low. UPS's Petition shows how these problems can be addressed.

UPS has experienced first hand the distortions to competitive markets caused by the Postal Service's pricing behavior. In September 2014, for example, the Postal Service cut prices for Priority Mail well below those of its private competitors in the market. As the following diagram from *The Wall Street Journal* shows, the Postal Service dropped its prices below those of private competitors in each and every identified cost category: Where the Postal Service was already the "low cost" provider, the price gap widened. Where the Postal Service's prices had previously been somewhat higher than its private competitors in some rate cells, the Postal Service made deep and targeted rate cuts yielding, in some cases, a significant price advantage for customers shipping at heavier weights.¹⁶

¹⁶ Laura Stevens, *U.S. Mail Cuts Prices, Chafing UPS and FedEx*, WALL ST. J. (Sep. 4, 2014), <http://www.wsj.com/articles/u-s-mail-cutting-rates-to-win-e-commerce-business-1409850185>.

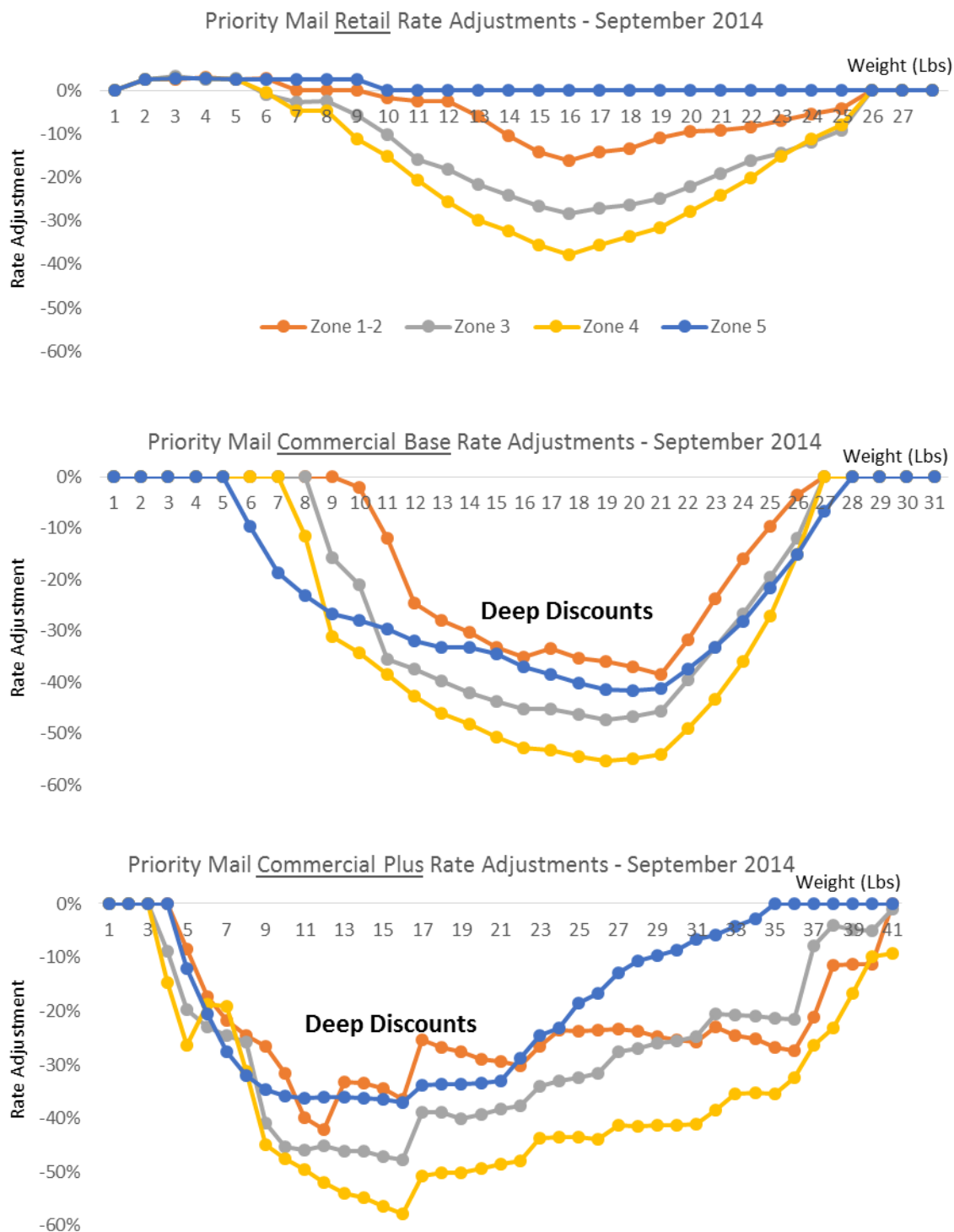


When it notified the Commission of these changes, the Postal Service stated that it was dropping Priority Mail rates for Commercial Base and Commercial Plus by an average of 0.9% and 2.3%, respectively, with an offsetting average rate increase of 1.7% for Retail Priority Mail shipments.¹⁷

As depicted in the graphs below, however, within those commercial rate categories the Postal Service reduced rates as much as 58% for packages shipping to zones 1-5 and weighing between six and twenty pounds, the rate cells most popular for the burgeoning e-commerce market. These deep discounts brought Priority Mail rates for the largest customers substantially below rates set by private competitors in the market.¹⁸

¹⁷ Dkt. No. CP2014-55, *Notice of the United States Postal Service of Changes in Rates of General Applicability for Competitive Products* at 1 (Jul. 1, 2014).

¹⁸ These graphs are adapted from the charts filed by FedEx in the docket dedicated to the competitive price decreases. Dkt. No. CP2014-55, FedEx Comments, Exhibits 1-1, 1-2, and 1-3 (Jul. 17, 2014). FedEx created its graphs by comparing the rate tables in the Postal Service's price decrease notice with the rate tables then in use to create the discount percentages. Compare Dkt. No. CP2014-55, *Notice of the United States Postal Service of Changes in Rates of General Applicability for Competitive Products* (Jul. 1, 2014), with Dkt. No. CP2014-5, *Notice of the United States Postal Service of Changes in Rates of General Applicability for Competitive Products* (Nov. 13, 2013).



Although the most recent rate adjustments scheduled to go into effect in January 2016 increase Priority Mail rates for Commercial Base and Commercial Plus customers, the deep discounts from pre-September 2014 rates remain. Despite an announced

average increase of 9.4% for Commercial Base prices in 2016, for example, discounts ranging from 7% to 53% below pre-September 2014 rates remain for packages weighing between six and twenty pounds.¹⁹ The same is true for Commercial Plus rates, where discounts remain between 9% and 44% for packages in the same weight range.

There can be no doubt that the Postal Service enacted these deep discounts to gain market share at the expense of private competitors. In its July 1, 2014 filing announcing the drastically decreased rates, the Postal Service stated that prices were being “adjusted to enhance Priority Mail’s strategic position in the market.”²⁰ Multiple news outlets discussing the price drops observed that the Postal Service’s goal was to increase market share.²¹ Industry insiders spoke of customers flocking to take advantage of the massive discounts.²²

¹⁹ Compare Dkt. No. CP2016-9, *Notice of the United States Postal Service of Changes in Rates of General Applicability for Competitive Products* (Oct. 16, 2015), with Dkt. No. CP2014-55, *Notice of the United States Postal Service of Changes in Rates of General Applicability for Competitive Products* (Jul. 1, 2014).

²⁰ Dkt. No. CP2014-55, *Notice of the United States Postal Service of Changes in Rates of General Applicability for Competitive Products* at 1 (Jul. 1, 2014).

²¹ See, e.g., Post & Parcel, *USPS Seeks e-Commerce Market Share with Priority Mail Price Cut* (Jul. 2, 2014), <http://postandparcel.info/61751/news/markets/usps-seeks-e-commerce-market-share-with-priority-mail-price-cut/> (“The US Postal Service is moving to snap up market share in e-commerce shipping with a lowering of its business prices.”); Trefis, *USPS’ Rate Reductions May Pose A Threat To UPS And FedEx’s Market Share* (Aug. 21, 2014), <http://www.trefis.com/stock/ups/articles/252456/usps%E2%80%99-rate-reductions-may-pose-a-threat-to-ups-and-fedex%E2%80%99s-market-share/2014-08-21> (“Therefore, a reduction in rates by USPS, followed by an increase in rates by UPS and FedEx, will lead to USPS’ rates being significantly lower than that of UPS and FedEx. E-commerce players will likely shift to USPS given its lower rates, leading to a decline in UPS and FedEx’s market share.”).

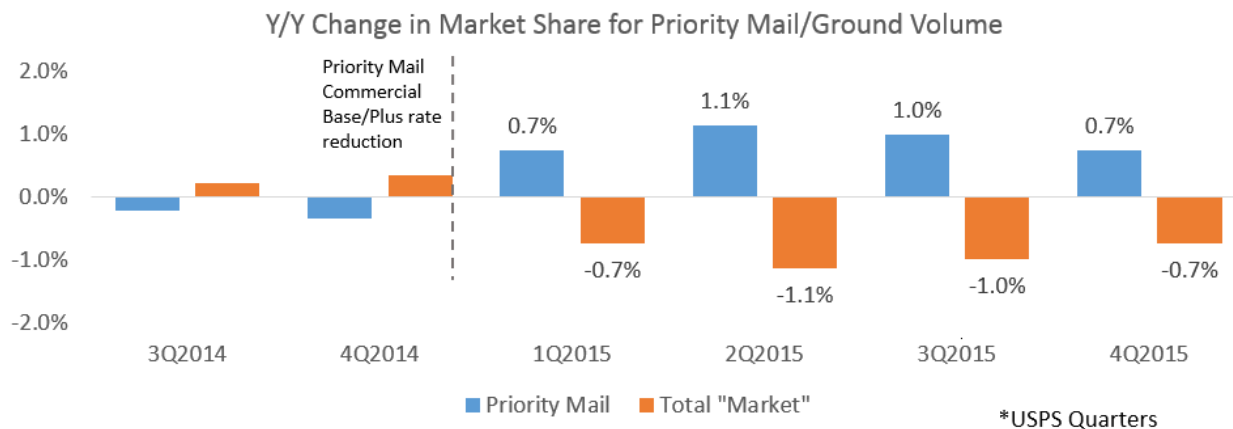
²² See, e.g., Laura Stevens, *U.S. Mail Cuts Prices, Chafing UPS and FedEx*, WALL ST. J. (Sep. 4, 2014), <http://www.wsj.com/articles/u-s-mail-cutting-rates-to-win-e->

Predictably, the Postal Service's market share increased sharply after the September 2014 rate reductions, as evidenced in the following charts.²³ The first chart below shows that the Postal Service gained share in the total Priority Mail and Ground market over the past year, much of which has come at the expense of UPS Ground and FedEx Ground.²⁴ While minor fluctuations in market share occur every quarter, the recent gain is higher and more sustained than seen in the past. Following the rate reduction, the Postal Service gained share in four consecutive quarters, enjoying growth at or above 1.0% in the second and third quarter of 2015.

commerce-business-1409850185 ("A number of e-commerce shippers are considering or have decided to use the Postal Service because of the price change, said Rob Martinez, president of Shipware LLC, a shipping strategy consultant and auditor. "A lot of shippers are going to take another look at the Postal Service."); Laura Stevens, *U.S. Postal Service Tries Hand as Fishmonger, Grocer*, WALL ST. J. (Aug. 17, 2015), <http://www.wsj.com/articles/u-s-postal-service-tries-hand-as-fishmonger-grocer-1439855940> ("Keith Byrd, co-founder of shipping consultancy Transportation Impact LLC, says more of his customers have either considered or have shifted parts of their package volume to the Postal Service in recent months. "Absolutely [the postal service is] taking market share from the small parcel carriers, especially on the lighter-weight e-commerce," he added.").

²³ Volume data used to derive share for UPS and FedEx was sourced from public quarterly filings. See, e.g., United Parcel Service, Inc., Quarterly Report (Form 10-Q) (Nov. 5, 2015). Priority Mail information was sourced from the Postal Service's Revenue, Pieces, and Weight reports. "All Priority Mail" represents year-over-year growth in Priority Mail volume for the respective quarter. "UPS/FedEx" represents the change in market share for UPS and FedEx, where market share is the sum of UPS ground volume and FedEx Ground volume for each quarter, divided by the sum of Priority Mail, UPS Ground, and FedEx Ground volume. Percentages represent the difference between the market share in a given quarter and the market share during the same period of the previous year.

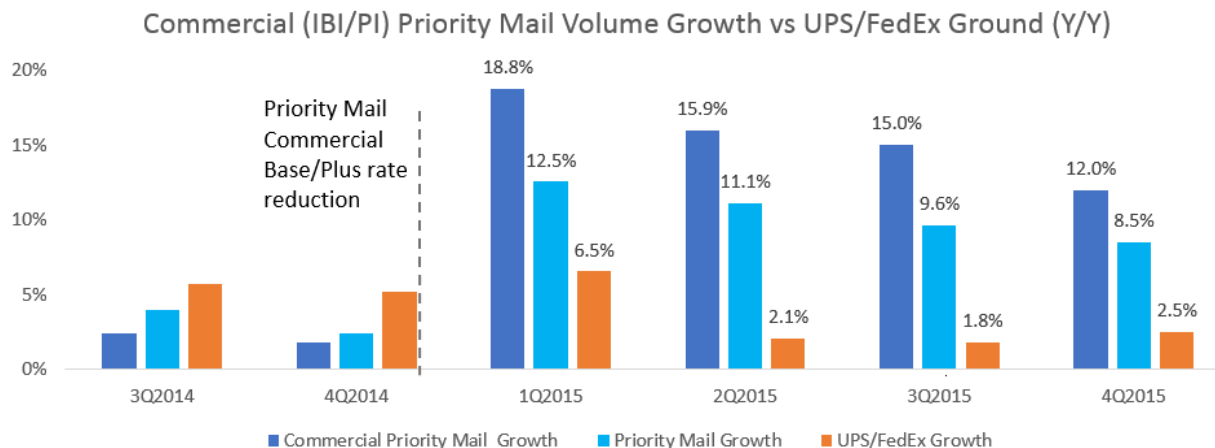
²⁴ UPS uses the calendar year for fiscal reporting; the Postal Service's fiscal year runs October to September; and FedEx's fiscal year runs June to May, creating some misalignment between the months represented in each quarter. To ease comparisons, this analysis uses UPS and FedEx data that most closely aligns to the Postal Service quarter. For example, in the graph, USPS Q4 2015 equals UPS Q3 2015 and FedEx Q1 2016.



As noted, the Postal Service's price decreases were most aggressive for commercial mailers, to whom the Postal Service offered discounts of up to 58%. While the Postal Service does not release package volume data that is separated into Retail, Commercial Base, and Commercial Plus categories, package volume data for Priority Mail pieces processed with Information Based Indicia ("IBI") and Permit Imprint ("PI") postage is an available proxy for commercial volume.²⁵ Comparing the year-over-year volume growth of commercial IBI/PI Priority Mail volume to that of total Priority Mail, and to that of UPS Ground and FedEx Ground combined, reveals staggering growth rates for Postal Service competitive commercial products, as shown in the following chart.²⁶

²⁵ Using IBI or PI qualifies Postal Service customers for Commercial Base and Commercial Plus pricing. See United States Postal Service, Domestic Mail Manual §§ 223.1.2 & 223.1.3.1 (Dec. 7, 2015), <http://pe.usps.com/text/dmm300/223.htm#1403989>. The Commission has recognized that Permit Imprint indicates "large commercial mailer use." Dkt. No. MC2015-7, Order No. 2686 at 10 (Aug. 26, 2015). IBI/PI postage represents about 80% of Priority Mail volume, indicating that these proxies are representative of commercial Priority Mail volume.

²⁶ Volume data for UPS and FedEx was sourced from public quarterly filings. Priority Mail information was sourced from the Postal Service's Revenue, Pieces, and Weight report. "Commercial Priority Mail Volume" was derived using volume data included in the Postal Service's Quarterly Statistics Report which provides product information by type of postage used. In this case, "Commercial (IBI/PI) Priority Mail" represents the sum of Priority Mail volume that was shipped using Information Based



Before the price cuts, the Postal Service’s market growth rate was limited, while UPS and FedEx were exhibiting healthy growth rates. After the Postal Service’s price cuts, the growth of UPS and FedEx Ground slowed, and the Postal Service’s commercial growth rates quickly increased at a rate between 3 and 8 times that of its private competitors.

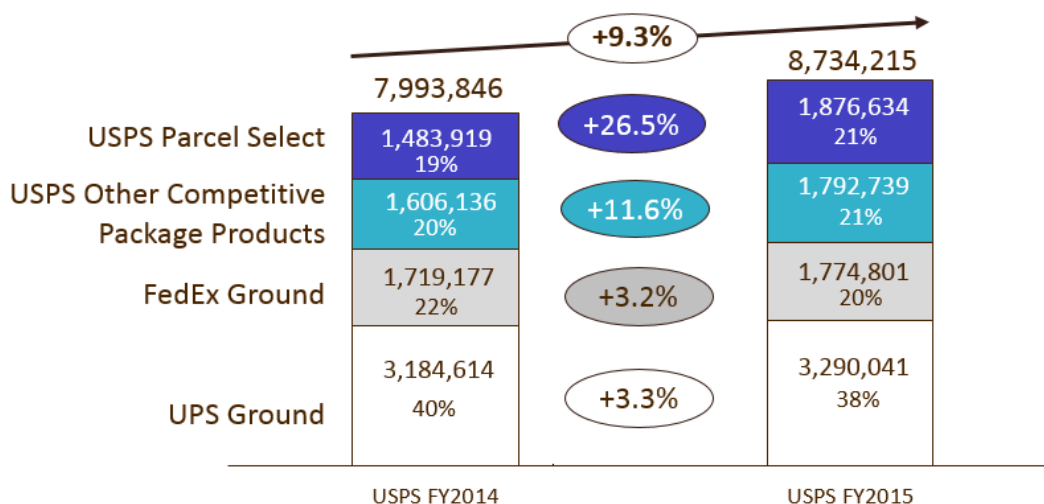
Although this discussion has focused on Priority Mail, which is the Postal Service’s flagship competitive product and the main beneficiary of the September 2014 rate decreases, the Postal Service has pursued aggressive market-share growth for other products as well. Parcel Select rates are also positioned below those of private competitors.²⁷ This gap is not the result of private competitors’ inefficiencies, but rather

Indicia and Permit Imprint postage. Growth rates represent volume growth over the same period the year prior.

²⁷ The Postal Service has two basic Parcel Select offerings: Parcel Select Ground (“end-to-end service”) and destination entry (“final mile delivery”). The latter is a work sharing program where third-parties (e.g., UPS, Amazon, and FedEx) induct their volume into the Postal Service primarily at the destination delivery unit and the Postal Service performs final mile delivery. The bulk of the dramatic growth in Parcel Select is believed to be in the final mile delivery offering. With respect to final mile delivery, the Postal Service is leveraging its network to such a degree that UPS and other carriers use Parcel Select to compete because they are not able to deliver at or below the prices the Postal Service charges for this service. As a result, Parcel Select destination entry

is due to the Postal Service’s ability to set artificially low rates. Not surprisingly, this has resulted in a dramatic market distortion. Over the last year, Parcel Select experienced *26.5% volume growth*, compared to 3.3% and 3.2% growth for UPS Ground and FedEx Ground, respectively, as illustrated in the graph below.²⁸

Volume Growth Trends for Top 3 Package Carriers: 2014-2015



If the Postal Service were able to achieve this type of significant and disruptive growth by outcompeting its private competitors on a level playing field, then that result would not run afoul of Congress’ mandate in PAEA. But the Postal Service is not competing on a level playing field. As the Public Representative in Dkt. No. CP2016-9 observed, and as UPS’s Petition shows, the Postal Service is currently able to set prices for competitive products that do not reflect all the costs attributable to those

is a sub-component of UPS SurePost and FedEx SmartPost. UPS SurePost and FedEx SmartPost results are reported within UPS Ground and FedEx Ground, respectively, as shown in the above figure.

²⁸ UPS and FedEx data sourced from public quarterly filings. See, e.g., United Parcel Service, Inc., Quarterly Report (Form 10-Q) (Nov. 5, 2015). Parcel Select information sourced from the Postal Service’s Revenue, Pieces, and Weight reports. “USPS Other Competitive Package Products” includes Priority Mail, First-Class Package Service, Standard Post Mail, and Parcel Return Service Mail.

products and that do not cover a reasonable share of the enterprise's institutional costs in light of current realities. And, as the facts laid out in this response show, the Postal Service is aggressively leveraging this uneven playing field to disrupt and distort competitive markets. This is the very type of conduct by a state-owned enterprise that Congress sought to guard against in PAEA.

Proposal One

3. **In its Petition, UPS discusses the basis for its conclusion that Proposal One complies with the requirements of 39 U.S.C. § 3633. *Id.*, Proposal One at 12. UPS also notes that its proposals “necessarily implicate letter mail costs as well.” Petition at 21. Please discuss whether Proposal One complies with the requirements of 39 U.S.C. § 3622, with particular emphasis on whether the proposal complies with the “reliably identified causal relationships” requirement of 39 U.S.C. § 3622(c)(2).**

UPS Proposal One is concerned with bringing Postal Service costing practices concerning competitive products into compliance with 39 U.S.C. § 3633, and it does not directly address the rate-setting process for market dominant products. UPS understands that the Commission has more flexibility in regulating the rates charged for market dominant products and can take a variety of factors into account. UPS does believe, however, that attributing inframarginal costs to individual market dominant products, using the existing distribution keys, would be consistent with the “reliably identified causal relationships” requirement of 39 U.S.C. § 3622(c)(2).

PAEA's provisions regarding cost attribution to individual products are effectively identical for competitive products and for market dominant products. In both cases, PAEA directs the products to bear the “costs attributable” to them. 39 U.S.C. § 3622(c)(2) (market dominant); 39 U.S.C. § 3631(b) (competitive). And those costs are defined, in both cases, as “the direct and indirect postal costs attributable to” the

respective product or class of service “through reliably identified causal relationships.”

39 U.S.C. §§ 3622(c)(2), 3631(b).

As UPS shows in Proposal One, inframarginal costs are the direct variable costs caused by products for every product delivered by the Postal Service except for the very last mail piece delivered. Since inframarginal costs are variable costs that are directly caused by changes in the volume of different mail products, they must be attributed to individual products under the plain language of PAEA — and in order to meet Congress’ clearly articulated legislative goals. But even if inframarginal costs somehow did not qualify as “direct” costs, PAEA expressly embraces attribution of “indirect” costs as well. 39 U.S.C. §§ 3622(c)(2), 3631(b). This further demonstrates that Congress intended robust attribution of variable costs to products.

Consistent with these principles, the Commission has recognized that inframarginal costs are variable costs that are causally related to volume and that can be included in the direct cost of a product. See Solicitation No. PRC-2014-2, RFP re: Study of Postal Service Institutional Cost at 4 (May 22, 2014) (“[Inframarginal] costs are causally related to volume and, in total, increase or decrease as volume increases or decreases.”); *id.* (since inframarginal costs are variable costs, “these costs can be included in the direct cost of a product”). The Commission has also rejected the Postal Service’s past attempts to justify limiting cost attribution to marginal costs alone.²⁹

²⁹ See Dkt. No. R97-1, Opinion and Recommended Decision on Postal Rate and Fee Changes at 233 (May 11, 1998) (“[T]he Commission cannot agree that marginal cost is all that is meant by the term ‘attributable.’ . . . The framers of the Act knew about and could have used the concept of marginal costs, but they did not. . . . In interpreting this language, the Commission continues to believe that the authors of the Act intended ‘attributable’ to mean more than just marginal cost. If they had meant marginal cost, they would have said so.”).

While this basic analysis applies equally to competitive products and market dominant products, there are differences between how these product categories are regulated. *First*, the requirement that all “costs attributable” to competitive products be attributed to individual products is a statutory command that permits no exceptions. On the other hand, the attributable cost “requirement” for market dominant products is treated more as a “factor,” as evidenced by the Commission’s conclusion that the rate cap takes precedence over attributable costs requirements and the fact that some market dominant products have long remained “underwater.”³⁰

Second, attributing inframarginal costs to individual *competitive* products is essential to meet Congress’ mandate in PAEA that those products compete fairly on a level playing field vis-à-vis products sold by private competitors – a mandate that does not apply to market dominant products. If inframarginal costs are not attributed to competitive products, then the Postal Service is able to set prices for competitive products in a way no private competitor could match, no matter how efficient. As shown in UPS’s Petition, that result violates the text, structure, and purpose of PAEA.

4. **UPS states that “[i]nframarginal costs are variable costs that exist in the many areas of operations in which the Postal Service enjoys economies of scale that take the form of a cost structure in which the unit cost of handling additional mail pieces declines as overall mail volumes increase.” *Id.*, Report of Dr. Kevin Neels at 10.**
 - a. **Please confirm that UPS contends that the Postal Service currently has increasing economies of scale and decreasing marginal costs;**

³⁰ See, e.g., GCA Response at 2 n.1 (citing Dkt. No. ACR2013, Annual Compliance Determination at 52-53 (Mar. 27, 2014) (allowing Standard Mail Flats to remain underwater for several years in a row without immediate corrective action); see also Dkt. No. R2010-4, Order No. 547 at 3 (Sep. 30, 2010) (“The plain language of the law, and a review of the legislative history of the law, both clearly indicate that the price cap can only be breached in certain, limited situations,” none of which is a general need for better cost coverage).

Confirmed, subject to the qualifications that follow. The Information Request asks whether the Postal Service is characterized by “*increasing* economies of scale.” The Postal Service does enjoy “economies of scale” — a term that refers to a situation in which average and perhaps marginal cost per unit decrease as the number of units increases. The Postal Service enjoys economies of scale in the sense that both average cost per unit and marginal cost per unit decline as weighted volume increases. Note that the qualifier “weighted” is necessary to account for the fact that work content per piece can vary significantly across products.³¹

UPS cannot confirm, however, that the Postal Service has decreasing marginal costs. When a production process characterized by economies of scale experiences decreases over time in volume, it can experience increases over time in marginal cost.

b. If confirmed, please provide all evidence relied upon to support this conclusion;

UPS refers the Commission to the work and workpapers of Charles McBride relating to the computation of inframarginal costs.³² Dr. McBride classifies Postal Service cost components into five categories: (1) entirely fixed; (2) partly fixed and partly variable; (3) entirely variable; (4) constant elasticity; and (5) those that take on the variability of some other component or set of components. For purposes of answering this request, only the first four categories are relevant, since those in category (5) depend on the first four directly or indirectly. The first two sets of cost components

³¹ If “volume” were measured simply as piece counts, it would be possible even in a production process characterized by economies of scale to have a situation in which volume growth were associated with a sufficiently marked shift in product mix toward products with higher work content that average and marginal cost per piece would increase as volume increased.

³² See Charles McBride, *Calculation of Postal Inframarginal Costs* (2014), <http://www.prc.gov/sites/default/files/reports/McBride%20092814.pdf>.

contain fixed costs. When these fixed costs are spread over larger volumes, the result is a decline in average cost. In constant elasticity cost segments the mathematical structure of the relationship between volume and cost is such that both marginal and average cost declines with increases in volume.

Given that the Postal Service's cost structure involves a weighted average of cost segments with no economies of scale, with declining average costs, and with declining marginal costs, the Postal Service's operations are, overall, characterized by economies of scale.

- c. **If not confirmed, please explain how UPS was able to reliably calculate inframarginal costs.**

N/A.

- 5. **Please provide a breakdown of the inframarginal costs of market dominant products, akin to the breakdown provided for competitive products, in Table 6 of the Report of Dr. Kevin Neels. *Id.* at 30.**

Table 1: Proposal One Cost Impacts w/ Product Detail (2014 \$ Millions)

Mail Class	Attributable Cost		Inframarginal Allocation - Last Mile		Proposal One	% of Current Costs
	[1]	[2]	[3]	[4]	[5]	[6]
Market Dominant Products						
Single-Piece Letters		5,710	2,593	1,274	8,304	145%
Single-Piece Postcards		266	115	62	381	143%
Total Single-Piece Letters and Cards		5,977	2,708	1,336	8,685	145%
Presort Letters		4,560	1,853	906	6,413	141%
Presort Cards		184	79	42	263	143%
Total Presort Letters and Cards		4,744	1,932	949	6,676	141%
Flats		1,566	431	110	1,997	128%
Parcels		543	179	41	722	133%
First-Class NSAs		13	-	-	13	100%
Outbound Single-Piece First-Class Mail Int'l		188	-	-	188	100%
Inbound Single-Piece First-Class Mail Int'l		249	-	-	249	100%
Total First-Class		13,280	5,250	2,436	18,530	140%
High Density and Saturation Letters		370	211	143	581	157%
High Density and Saturation Flats and Parcels		881	385	256	1,266	144%
Every Door Direct Mail Retail		39	29	21	68	174%
Carrier Route		1,686	543	298	2,229	132%
Letters		4,895	2,148	1,219	7,044	144%
Flats		2,497	556	180	3,053	122%
Parcels		103	23	7	125	122%
Standard Mail NSAs		63	-	-	63	100%
Total Standard Mail		10,534	3,895	2,124	14,429	137%
In County		86	27	18	112	131%
Outside County		2,048	478	164	2,527	123%
Total Periodicals		2,134	505	182	2,639	124%
Alaska Bypass		16	-	-	16	100%
Inbound Surface Parcel Post (at UPU Rates)		13	-	-	13	100%
Bound Printed Matter Flats		134	38	11	172	128%
Bound Printed Matter Parcels		251	86	43	337	134%
Media and Library Mail		328	95	18	423	129%
Total Package Services		743	219	71	961	129%
International Negotiated Service Agreements		143	-	-	143	100%
Free Mail - blind, handicapped & servicemen		40	9	3	49	123%
Total Market Dominant Mail		26,874	9,877	4,816	36,751	137%
Total Domestic Ancillary Services		905	-	-	905	100%
Total International Ancillary Services		13	-	-	13	100%
Total Special Services		413	-	-	413	100%
Total Market Dominant Services		1,331	840	179	2,171	163%
Total Market Dominant Mail and Services		28,205	10,717	4,994	38,922	138%
Competitive Products						
Total Priority Mail Express		366	124	15	490	134%
Total First-Class Package Service		1,155	302	112	1,456	126%
Total Ground		2,472	837	364	3,309	134%
Total Priority Mail		5,234	1,204	171	6,439	123%
Total Competitive International		1,385	219	33	1,604	116%
Total Domestic Competitive Services		359	2	0	360	100%
Total Competitive Mail and Services		10,970	2,688	696	13,658	125%
TOTAL ATTRIBUTABLE COSTS		39,175	13,406	5,690	52,581	134%
OTHER COSTS		34,187	(13,406)	(5,690)	20,781	61%
TOTAL COSTS		73,362			73,362	

Notes and Sources:

[1]: Mail Classes reported in the FY14 Public Cost and Revenue Analysis (PCRA).

[2]: Attributable Costs as reported in the FY14 PCRA.

[3]:]: Additional attributable costs from Inframarginal costs allocated in Proposal One. Inframarginal costs are first allocated to Mail Classes in the CRA Cost Matrix B. The Inframarginal Costs allocated to the "U.S. Postal Service" mail class in the CRA Cost Matrix B have been distributed between CRA Cost Matrix B "Total Market Dominant" mail classes according to their Inframarginal Cost Allocations. The Inframarginal Costs allocated to the "International Mail and Services" mail class in the CRA Cost Matrix B are split between Market Dominant and Competitive based on the ratio of "Total Competitive International" Attributable Costs reported in the PCRA to "International Mail and Services" Attributable Costs for Component 460 reported in CRA Cost Matrix B. The Market Dominant International Costs are then distributed to Market Dominant Cost Matrix B mail classes according to their Inframarginal Cost Allocations. The CRA Cost Matrix B mail classes were then matched (when possible) to mail classes reported in the PCRA. The mail classes and associated costs in the Cost Matrix B do not directly match what is reported in the PCRA. Thus the additional costs for both Proposals here are estimates.

[4]: A subset of the costs in [3] for components in Cost Segments 6, 7, and 10.

[5]: [2] + [3].

[6]: [5] / [2].

Column [4] – titled "Inframarginal Allocation – Last Mile" – represents the sum of cost impacts for Cost Segments 6, 7, and 10, which are City Delivery Carriers – Office (CS 6), City Delivery Carriers – Street (CS7) and Rural Carriers (CS 10). This column may be of interest to mailers who rely on work sharing to control their mailing costs and may, therefore, have the ability to mitigate any cost coverage decreases arising from the attribution of inframarginal costs.

6. Please provide an estimate of the total subsidy received by competitive products from market dominant products, net of the costs associated with the Universal Service Obligation.

Under 39 U.S.C. § 3633, unlawful subsidization occurs when competitive products fail to generate revenues sufficient to cover the full share of costs attributable to those products, both individually and as a group. Consistent with the analysis set forth in UPS's Petition, the following individual competitive products were subsidized in FY 2014:

- Under the costing methods resulting from the adoption of UPS Proposal One, the costs attributed to the competitive product category labeled

“Total Ground” would exceed the revenues generated by those products by \$149 million. In addition, neither Parcel Select nor Standard Post would individually generate revenues in excess of attributable costs.³³

- Under the costing methods resulting from the adoption of UPS Proposal Two, the costs attributed to Standard Post in FY 2014 would exceed the revenues generated by that product.
- Under the costing methods resulting from the adoption of both UPS Proposals One and Two, the costs attributed to First Class Package Service in FY 2014 would exceed the revenues generated by that product by \$92 million. The costs attributed to the competitive product category labeled “Total Ground” would exceed the revenues generated by those products by \$366 million. Again, neither Parcel Select nor Standard Post would individually generate revenues in excess of attributable costs.

UPS’s Petition also explains why the Commission should adopt an additional anti-subsidization test for *competitive products as a group*, in addition to the existing Incremental Cost Test currently in place. Under this additional test, the Postal Service must demonstrate that its revenues from competitive products as a group exceed the sum of the attributable costs of each competitive product, which includes the inframarginal costs attributable to each product and any product- and group-specific fixed costs attributable to competitive products.³⁴ Using figures from FY 2014, the

³³ UPS has not provided certain product-level information in this response of the type that the Postal Service has traditionally treated as non-public.

³⁴ As explained in the Petition, this additional test is necessary to address the ordering-bias inherent in the existing Incremental Cost Test, which assumes that

Postal Service would pass this additional test for competitive products as a group, albeit by a more narrow margin than it passed the existing Incremental Cost Test.³⁵

Neither this new test nor the existing Incremental Cost Test, however, requires competitive products to account for *institutional* costs. The responsibility for that falls upon 39 U.S.C. § 3633(a)(3), which requires competitive products as a group to bear, in addition to their attributable costs, an “appropriate share” of institutional costs. Like the other provisions of § 3633, Congress included this requirement in order to meet its related goals of “ensur[ing] fair competition” and “prohibiting subsidization.” S. Rep. No. 108-318 at 15 (2004) (“[T]he appropriate share requirement is an important safeguard to ensure fair competition on the part of the Postal Service.”); H.R. Rep. No. 109-66 at 48-49 (2005) (“Section 3633 requires the Postal Regulatory Commission to promulgate regulations within 18 months of enactment prohibiting subsidization of competitive products by market dominant products. The Commission shall ensure that each competitive product covers its attributable costs, and in addition ensure that competitive products collectively make a ‘reasonable contribution’ to the institutional costs of the Postal Service.”).

UPS Proposal Three updates the initial “appropriate share” level set by the Commission after PAEA to bring it into line with Congress’ directives in light of the current landscape, including the much greater attention being paid to competitive products by the Postal Service. If UPS Proposals One, Two, and Three are each adopted, the revenues generated by competitive products as a group in FY 2014 would

competitive products come last on the cost curve and are responsible as a group only for the least expensive variable costs.

³⁵ Specifically, this test would yield \$14.41 billion in costs for competitive products as a group, as compared to \$15.28 billion in revenue.

fall short of the sum of their attributable costs and assigned share of institutional costs by approximately \$2.7 billion.³⁶

UPS is, however, unable to estimate any of these results “net of the costs associated with the Universal Service Obligation” for several reasons. *First*, the question of whether each individual product is covering all costs attributable to that product under § 3633(a)(2) does not require or permit any netting of other costs arising from other obligations. Engaging in such a netting process would be inconsistent with PAEA’s plain language. Section 3633(a)(2) requires that *each* competitive product cover all of its “costs attributable,” which are defined to be “the direct and indirect postal costs attributable to such product through reliably identified causal relationships,” 39 U.S.C. § 3631. Any costs associated with the universal service obligation are irrelevant to the costs that are attributable to individual competitive products and thus have no role in fulfilling this statutory command.

Second, there is no basis for assuming that the universal service obligation imposes a *net cost* on the Postal Service. This is in part because costs associated with the universal service obligation cannot be easily isolated or quantified. As the Commission has noted, “a consensus does not exist on the method or utility of assigning a cost to the [universal service obligation] and postal monopolies.” Postal Regulatory Commission, *Report on Universal Postal Service and the Postal Monopoly* at 228 (Dec. 19, 2008), <http://www.prc.gov/docs/61/61628/uso%20report.pdf>.

Numerous methods have been proposed for estimating costs associated with the

³⁶ Even under the current 5.5% appropriate share, the Postal Service’s competitive products business would still be falling short by approximately \$92 million dollars.

universal service obligation, and these methods vary considerably both in how they define the obligation and how they calculate its costs. See *id.* at 101-52. This variation arises because the universal service obligation is not itself specific, and the Postal Service is allowed flexibility in meeting it, while balancing the delivery of service against budgetary constraints.³⁷

But even if the costs associated with the universal service obligation could be reliably calculated, they cannot be considered in isolation from the corresponding *benefits* enjoyed by the Postal Service. As the Supreme Court has recognized, Congress granted the Postal Service a very valuable “monopoly over the carriage of letters” as “a revenue protection measure” to enable the Postal Service to maintain its universal service obligation. *Air Courier Conference of America v. American Postal Workers Union AFL-CIO*, 498 U.S. 517, 519 (1991). The Federal Trade Commission has likewise observed that “[t]o fund this universal service obligation, Congress has granted the USPS two monopolies” (*i.e.*, the letter and mailbox monopolies). Federal Trade Commission (“FTC”), *Accounting for Laws that Apply Differently to the United States Postal Service and its Private Competitors* at 6 (Dec. 2007), <https://www.ftc.gov/reports/accounting-laws-apply-differently-united-states-postal-service-its-private-competitors>. The Postal Service has repeatedly invoked its monopolies as being necessary to offset the costs of the universal service obligation. See, *e.g.*, Postal Regulatory Commission, *Report on Universal Postal Service and the*

³⁷ In its FY 2014 report, for example, the Commission noted that the Postal Service reduced the cost of providing nationwide service by over \$250 million by closing post offices and consolidating delivery routes. See Postal Regulatory Commission, *Annual Report to the President and Congress: Fiscal year 2014* at 40-41 (Jan. 5, 2015).

Postal Monopoly at 187; Postal Regulatory Commission, *Annual Report to the President and Congress: Fiscal Year 2014* at 47-48.

And the benefits from these monopolies are substantial. The letter monopoly has been valued as conferring over \$7 billion in benefits to the Postal Service, without even considering the implicit subsidies the Postal Service also enjoys. See Postal Regulatory Commission, *Report on Universal Postal Service and the Postal Monopoly* at 143-47.³⁸

The Postal Service also enjoys substantial economies of scope and scale that flow from its monopoly over the mail. As the FTC has found, “[t]he ability to share the network established to deliver products covered by the postal monopoly,” as a result of the universal service obligation, “may reduce the USPS’s cost of providing competitive products.” FTC, *Accounting for Laws that Apply Differently to the United States Postal Service and its Private Competitors* at 47. Further, “apart from economies of scope . . . the network of retail outlets that exists due to the postal monopoly also likely provide the USPS’s competitive products an advantage” as the universal service obligation “results in the USPS having many more retail outlets than it would otherwise.” *Id.* at 51; see *also* Shapiro at 14 (“Meeting its universal service obligations also confers significant

³⁸ The Postal Service enjoys large implicit subsidies by virtue of its status as a federal government entity: it is able to avoid costs associated with various federal, state, and local legal requirements; it receives preferential interest rates on its debt; and it enjoys eminent domain power and limits on the extent to which it can be sued. The Federal Trade Commission estimated the value of this subsidy in 2006 as between \$39 million to \$117 million annually. See Federal Trade Commission, *Accounting for Laws that Apply Differently to the United States Postal Service and its Private Competitors* at 8-9. Cf. Robert J. Shapiro, *The Basis and Extent of the Monopoly Rights and Subsidies Claimed by the United States Postal Service* at 3 (Mar. 2015), http://www.sonecon.com/docs/studies/Study_of_USPS_Subsidies-Shapiro-Sonecon-March_25_2015.pdf (estimating that “USPS monopolies and related special treatment produce effective subsidies [are] worth nearly \$18 billion per-year”).

economies of scale and scope on the USPS, creating economic benefits unavailable to private businesses.”).

Putting this together, as a group of Commission economists have concluded, “the advantage of scale economies in delivery, name recognition, established relationships and incumbency . . . *more than offset* the burden of the USO in a competitive situation.” Robert Cohen *et al.*, *The Cost of Universal Service and its Impact on Competition* (2002), *available at* <http://www.postalreporter.com/cost.htm#cost> (emphasis added). In other words, the universal service obligation and its associated monopolies may well confer a *net benefit*, not a net cost, on the Postal Service.

Notably, however, UPS Proposal One does, to some degree, take into account the scale economies associated with the universal service obligation and the letter monopoly. As noted in the Petition, theoretically, requiring the Postal Service to compete with private carriers on a level playing field could require the Postal Service to account for competitive costs on a stand-alone basis. Practically, this would result in competitive products covering the more expensive “earlier” or leftmost variable costs on the constant elasticity cost curve.

UPS Proposal One, however, does not seek that result. Instead, it proposes an addition to the existing “Incremental Cost Test” that would essentially require competitive products as a group to bear only the *average* variable costs of the products, by using an “order neutral” approach. The existing Incremental Cost Test makes the ordering assumption that competitive products and services are tacked on to a pre-existing market dominant infrastructure. As explained in UPS’s Petition, this treatment of competitive products assigns the *cheapest* variable costs to competitive products

while assigning the *most expensive* variable costs to market dominant products and services.

UPS Proposal One's order neutral approach would require competitive products as a group to assume a more reasonable share of the Postal Service's variable costs, but it would still allow those products to retain their *pro rata* share of the advantages of the economies of scale arising from the letter monopoly and universal service obligation. In other words, under UPS Proposal One, the Postal Service's competitive products business would still be able to retain some benefits of the economies of scale associated with the letter monopoly; it would just not be able to retain *all* of those benefits. Instead, it would share them fairly with market dominant customers.

7. **Please confirm if Dr. Neels (or any other expert for UPS) performed any analysis to assess whether there are any hidden fixed costs within reported attributable or inframarginal costs. If so, please provide all statistical results and all supporting workpapers for such analyses. If not, please explain why no such analyses were performed.**

Neither Dr. Neels nor any other expert for UPS performed tests to determine whether reported attributable or inframarginal costs contain hidden fixed costs, for the following reasons.

First, such an investigation would be technically complex, inordinately time-consuming, and expensive. The attributable costs currently reported by the Postal Service are based upon a complex set of assumptions, data sources, and analyses whose nature and sophistication varies significantly from component to component. Evaluating and testing fairly each of the wide range of models and analyses underlying currently reported attributable costs would have been a monumental undertaking, without enough likely probative value to justify the time and resources required.

This same limitation, however, did not apply to analyzing reported fixed costs in connection with UPS Proposal Two. As Dr. Neels explained in his report, in the case of reported fixed costs there is no incumbent model to consider or modify. These costs are supposed to remain constant as volume changes. Basic statistical tests are sufficient to establish whether they behave as their categorization suggests they should. Dr. Neels concluded that many did not do so.

Second, based on his decades of experience and his analyses of Postal Service data, Dr. Neels did not expect such an effort would produce much in the way of new or useful results. Dr. Neels has concluded based on his work with many different businesses and organizations that most organizations tend to underestimate the variability of their costs. In addition, based on nearly twenty years of empirical research on postal issues, Dr. Neels has concluded that the Postal Service in particular tends to *understate*, not overstate, the variability of its costs. As a result, Dr. Neels did not believe the additional months required to deconstruct incumbent costing models would yield results sufficiently probative to justify the burden.

Notably, Dr. Neels found far more components in which fixed costs appeared to vary directly with changes in volume than there were in which fixed costs appeared to vary inversely with volume. See Neels Report at 41-42. As explained by Dr. Neels, this result persuasively shows that the Postal Service has a systematic tendency to overstate its fixed costs. *Id.*

Finally, if any party has an incentive to locate hidden fixed costs, it is the Postal Service, since locating such costs would expand its pricing freedom by increasing the amount of fixed costs that are overwhelmingly borne by market dominant products. The

fact that, despite all the effort and resources the Postal Service devotes to its costing models, it has apparently not successfully found such costs indicates that the Postal Service itself does not believe a significant quantity of “hidden” fixed costs exists.

Proposal Two

8. **Dr. Neels states that “[t]he measure of work-content-weighted volume I use in this analysis is equal for each year to the summation across all postal products of the number of mail pieces handled in that year by the Postal Service multiplied by the per unit attributable costs in 2014 for that category of mail.” *Id.* at 34.**

a. **Please provide an economic rationale for using “work-content-weighted volume” instead of a different measure of volume (e.g., total volume) in the fixed costs regression analysis;**

The Postal Service handles a number of different types of mail that place very different demands on the different parts of its operations. The various products handled by the Postal Service differ in term of weight, volume, and the degree of pre-processing they have undergone before being tendered to the Postal Service. Work-content weighted volume captures these diverse cost-causing characteristics.

Notably, in using weighted volume in this way, Dr. Neels followed precedent established by the Postal Service and endorsed by the Commission. As discussed in UPS’s Petition and Dr. Neels’ report, Postal Service costing procedures routinely employ “cost drivers” selected to capture the most relevant cost-causing features of the mail stream. The number of cost driver units per piece typically varies across mail products.

b. **Please explain whether Dr. Neels’ statistical results or economic conclusions might change if differently defined volumes were used in the regression analysis and why those changes might occur.**

Dr. Neels’ statistical results could change if his analysis were rerun using different volume measures, but in the absence of specific data or specific alternative

proposals, UPS is unable to speculate about why or under what circumstances particular changes might occur. Moreover, Dr. Neels has not identified any reason to question his principal economic conclusion – namely, that the costs the Postal Service regards as fixed have a tendency in a large number of components to vary significantly with changes in volume.

9. **Please refer to the Report of Dr. Kevin Neels, pages 36-37, where Dr. Neels presents the results of the regression analysis of inflation-adjusted fixed costs on total weighted volume.**

a. **Please explain why data for the fiscal years prior to 2007 were not included in this analysis;**

The principal reasons why data for fiscal years prior to 2007 were not analyzed had to do with limitations in the Postal Service's data. In particular, there were significant differences in the ways in which mail classes and individual products were categorized in the 2007 and 2008 RPW reports. For instance, in the 2007 Public B report, Standard Mail - Enhanced Carr Rte is assigned mail class number 126. Beginning in 2008, this class appears to be split into three subsets: Standard Mail - High Density and Saturation Letters (mail class 21), Standard Mail - High Density and Saturation Flats and Parcels (mail class 22), and Standard Mail - Carrier Route (mail class 23). Grouping these three mail classes to match back to 2001-2007's Standard Mail - Enhanced Carr Rte would entail losing the product-level detail contained in the 2008-2014 data.

As a further example, in the 2007 RPW report, a large component of First Class Mail is reported as Single-Piece Letters, Flats, & Parcels. Beginning in 2008, mail classes are reported separately as First Class Mail - Single-Piece Letters, First Class Mail - Flats, and First Class Mail - Parcels, which have their own distinct revenue,

volume, and cost information in reports from the 2008-2014 period. Note that although the 2007 RPW reports employ different product groupings than the reports from the following years, using prior year information from the 2008 report Dr. Neels was able to obtain comparable data for 2007, and thus was able to include that year in his analysis.

Changes such as these made it difficult to produce consistently defined volume data for a longer time period.

- b. **Please confirm whether the regression analysis was run using any data sets that included observations for other fiscal years. If confirmed, please provide the statistical results and all supporting workpapers for such analyses. If not confirmed, please explain why such alternatives were not explored;**

It was not, for the reasons outlined above.

- c. **Please confirm whether, prior to the regression analysis being run, any statistical tests (e.g., a test for normality) were performed on the volume data. If confirmed, please provide the results and all supporting workpapers for such tests. If not confirmed, please explain why such tests were not performed;**

No statistical tests were run on the volume data prior to the regression analysis being run. The standard regression model assumes that regression error terms are normally distributed, but it does not require the independent variables used in the regression to be normally distributed.

- d. **Please explain whether other factors (besides work-content-weighted volumes) could explain the change in fixed costs over time;**

There is always a theoretical possibility that some factor other than changes in work-content-weighted volume might account for these results. Dr. Neels' work, however, did not identify any other factors that could explain his results.

- e. **Please indicate if Dr. Neels (or any other expert for UPS) performed any regression analyses with explanatory variables or regression specifications different from those presented in the Report of Dr. Kevin Neels. If so, please provide the statistical results and all**

supporting workpapers for such analyses. If not, please describe in detail all the obstacles to performing such analyses.

Members of Dr. Neels' staff conducted preliminary explorations of alternative specifications involving either the addition of a variable measuring the weighted volume for competitive products or the addition of a variable measuring weighted volume squared. These results were, however, never finalized or audited. Without reviewing the preliminary results of these analyses in any detail, Dr. Neels concluded that the limited number of observations that were available would not allow measurement of the effects of any additional explanatory variables with an adequate degree of precision. Accordingly, he did not consider this work in connection with the Petition.

10. **Dr. Neels states that, “[i]n particular, I accept Postal Service costing for components when the regression results in a negative coefficient on weighted volume. Taken on its face, this result would imply that adding mail to the system reduces fixed cost – a result that I find a priori to be implausible.” *Id.* at 43.**

a. **Please confirm that, according to Dr. Neels' interpretation, a positive coefficient on weighted volume implies that variable costs for a given component are understated, meaning that a portion of “reported fixed cost” is variable. If not confirmed, please explain.**

Confirmed.

b. **Please also confirm that, following the same logic, a negative coefficient on weighted volume implies that variable costs for a given component are overstated. If not confirmed, please explain.**

Not confirmed; this logic does not hold in the same way in the case of a negative relationship between fixed costs and weighted volume. Instead, any results showing a negative coefficient on weighted volume would have to be considered in conjunction with the specific costing procedures and models that were employed to compute variable costs for the component in question. The varied nature of costing procedures employed by the Postal Service, which can involve the use of multiple cost drivers and

complex nonlinear forms, makes it impossible to provide a general answer to the question posed.

In addition to this inherent complexity, a negative coefficient on weighted volume does not necessarily imply that variable costs are overstated. This conclusion would be theoretically possible only if there were a negative coefficient in a component that was partly fixed and partly variable *and* if the sum of the “negative hidden variable costs” and the positive stated variable costs were still non-negative. If that sum were instead negative (which would always be the case if one found a negative coefficient in a component which is entirely fixed), then the implication of the negative coefficient would be that costs go down as volume goes up. As Dr. Neels explained in his report, that result does not make sense and is likely best explained as statistical noise.

11. **Please explain the constraints imposed by running a regression between weighted volume and reported fixed costs without a constant for those components with: 1) negative constants and positive significant slopes; or 2) negative constants and negative significant slopes, as described in the Report of Dr. Kevin Neels. *Id.* at 44.**

The imposed constraints involve suppression of the constant term in the regression. Graphically, such a constraint is equivalent to forcing the regression line to run through the origin in a graph with cost on the vertical axis and weight volume on the horizontal axis.

12. **Please provide the following costs:**

- a. **The costs of each component with a negative and significant slope line, akin to the breakdown for positive slopes in Table 11 of the Report of Dr. Kevin Neels;**

The requested information is shown in Table 2 below, which mirrors the format of Table 11 in Dr. Neels’ report. Note that the components in which the coefficient on

weighted volume was negative and significant accounted for \$4.8 billion in cost, while the components in which the coefficient on weighted volume was positive and significant accounted for \$9.5 billion (*i.e.*, \$4.6 plus \$4.9) in cost.

Table 2: Regression Results w. Negative Slope Detail

Slope Coefficient Sign in Reg w/ Constant			Component Count	2014 Attributable Costs (\$ M)	2014 Inframarginal Costs (\$ M)	2014 Fixed Costs (\$ M)	2014 Total Cost (\$ M)
[1]	Category Description		[3]	[4]	[5]	[6]	[7]
Positive	Reg w/ Constant	<i>Significant Slope</i>	[A] 6	1,914	-	2,722	4,636
		<i>Insignificant Slope</i>	20	2,503	215	3,957	6,675
	Reg w/o Constant	<i>Significant Slope</i>	[B] 31	3,403	158	1,308	4,869
	Negative Constant In Reg w/ Constant and Insignificant Slope in Reg w/ Constant		[C] 10	74	-	134	208
	Total		[D] 67	7,894	373	8,121	16,388
Negative	Negative Slope	<i>Significant Slope</i>	[E] 8	2,285	271	2,210	4,766
		<i>Insignificant Slope</i>	9	2,220	-	9,941	12,160
	Total		[F] 17	4,505	271	12,151	16,926
Not Modeled			[G] 86	27,132	12,762	154	40,048
Total			[H] 170	39,530	13,406	20,426	73,362

Notes and Sources:

[1]: Sign of Slope Coefficient for components modeled in Regression with Constant.

[2]: Category of components used to determine updated Proposal Two costing.

[3]: Components are the most granular components in the 2014 ACR USPS CRA Model Public B Cost Matrix.

[4]: TOTAL ATTRIBUTABLE COSTS as reported in the 2014 ACR USPS CRA Model Public B Cost Matrix, differences due to rounding.

[5]: Inframarginal Costs calculated following McBride's methodology applied to 2014.

[6]: OTHER COSTS as reported in the 2014 ACR USPS CRA Model Public B Cost Matrix less [5], differences due to rounding.

[7]: TOTAL COSTS as reported in the 2014 ACR USPS CRA Model Public B Cost Matrix, differences due to rounding.

[A]: Components for which fixed cost regression resulted in a positive slope coefficient and constant.

[B]: Components for which fixed cost regression resulted in a positive slope coefficient and negative constant. Regressions were re-estimated to exclude the constant.

[C]: Components for which fixed cost regression resulted in a positive, insignificant slope coefficient and a negative constant.

[D]: [A] + [B] + [C].

[E]: Components for which fixed cost regression resulted in a negative slope coefficient.

[F]: Sum of components with negative slope coefficient in the Regression with Constant.

[G]: Domestic Alaska Air and other components that were not modeled because OTHER COSTS reported in the USPS CRA Model Public B Cost Matrix were less than or equal to zero for any year between 2007 - 2014.

$$[H]: [A] + [B] + [C] + [E] + [G].$$

- b. **The hidden variable cost for each cost component with a negative slope, using the same methodology as used in Table 14 of the Report of Dr. Kevin Neels;**

The requested information is shown in Table 3 below.

Table 3: Negative Slope Implied Costs (2014 \$ Thousands)

Cost Segment Name [1]	Comp [2]	Component Name [3]	Reported Costs				Hidden Variable Cost [8]	Costs Adjusted for Hidden Variable Costs		
			Total Cost [4]	Fixed Cost [5]	Inframarginal Cost [6]	Attributable Cost [7]		Implied Fixed [9]	Implied Attributable [10]	
Significant Coefficients										
C/S 2 Supervisors and Technicians	678	Joint Supervision Clerks & Carriers	\$ 891,700	\$ 68,361	\$ 243,563	\$ 579,775	\$ (21,881)	\$ 90,242	\$ 557,894	
C/S 6 City Delivery Carriers – Office Activity	604	In-Office Support Other	\$ 662,634	\$ 337,110	\$ -	\$ 325,525	\$ (130,720)	\$ 467,830	\$ 194,804	
C/S 12 Motor Vehicle Service	548	Rural Delivery	\$ 94,711	\$ 60,134	\$ -	\$ 34,577	\$ (71,417)	\$ 131,551	\$ (36,840)	
C/S 12 Motor Vehicle Service	556	Rural Delivery	\$ 234,249	\$ 148,728	\$ -	\$ 85,521	\$ (231,111)	\$ 379,839	\$ (145,590)	
C/S 16 Supplies and Services	174	ADP Supplies & Services	\$ 704,666	\$ 685,464	\$ -	\$ 19,202	\$ (306,036)	\$ 991,500	\$ (286,834)	
C/S 18 Administration and Area Operations	204	Workers Comp Current Year [VA\ report]	\$ 1,974,682	\$ 883,563	\$ -	\$ 1,091,119	\$ (1,009,158)	\$ 1,892,721	\$ 81,961	
C/S 18 Administration and Area Operations	895	OWCP Health Benefits	\$ 21,442	\$ 21,442	\$ -	\$ -	\$ (27,344)	\$ 48,785	\$ (27,344)	
C/S 20 Other Accrued Expenses (Servicewide)	587	Interest Land / Building Veh & Equip	\$ 181,749	\$ 5,002	\$ 27,275	\$ 149,472	\$ (12,751)	\$ 17,753	\$ 136,721	
Significant Coefficient Total:			\$ 4,765,833	\$ 2,209,804	\$ 270,839	\$ 2,285,190	\$ (1,810,418)	\$ 4,020,222	\$ 474,772	
Insignificant Coefficients										
C/S 10 Rural Carriers	69	Evaluated Routes	\$ 5,992,970	\$ 3,788,604	\$ -	\$ 2,204,366	\$ (928,824)	\$ 4,717,429	\$ 1,275,542	
C/S 13 Miscellaneous Local Operations	117	Freight on Materials & Supplies	\$ 28,835	\$ 28,832	\$ -	\$ 3	\$ (29,855)	\$ 58,687	\$ (29,852)	
C/S 18 Administration and Area Operations	71	Annuitant Life Insurance	\$ 22,045	\$ 9,650	\$ -	\$ 12,396	\$ (4,762)	\$ 14,411	\$ 7,634	
C/S 18 Administration and Area Operations	203	Annuitant Health Benefits - Pre-Funded (Prior)	\$ 5,532,383	\$ 5,532,383	\$ -	\$ -	\$ (7,676,436)	\$ 13,208,819	\$ (7,676,436)	
C/S 18 Administration and Area Operations	205	Workers' Comp Prior Year	\$ 530,475	\$ 530,475	\$ -	\$ -	\$ (2,243,503)	\$ 2,773,978	\$ (2,243,503)	
C/S 18 Administration and Area Operations	212	Inspection Expenses & Employee Losses	\$ 7,785	\$ 7,783	\$ -	\$ 3	\$ (11,783)	\$ 19,566	\$ (11,780)	
C/S 18 Administration and Area Operations	1429	Individual Awards	\$ 17,710	\$ 17,697	\$ -	\$ 13	\$ (26,827)	\$ 44,524	\$ (26,814)	
C/S 18 Administration and Area Operations	1430	Miscellaneous Personnel Compensation	\$ 20,276	\$ 20,276	\$ -	\$ (0)	\$ (358,527)	\$ 378,804	\$ (358,527)	
C/S 20 Other Accrued Expenses (Servicewide)	582	Rural Delivery	\$ 7,936	\$ 5,039	\$ -	\$ 2,897	\$ (6,481)	\$ 11,520	\$ (3,584)	
Insignificant Coefficient Total:			\$ 12,160,416	\$ 9,940,738	\$ -	\$ 2,219,677	\$ (11,286,999)	\$ 21,227,737	\$ (9,067,321)	
GRAND TOTAL:			\$ 16,926,248	\$ 12,150,542	\$ 270,839	\$ 4,504,867	\$ (13,097,416)	\$ 25,247,958	\$ (8,592,549)	

Sources and Notes:

[1]-[3]: Components modeled in regression analysis with negative coefficients on weighted volume.

[4]: Total cost reported in the 2014 ACR USPS CRA Model Public B Cost Matrix.

[5]: OTHER COSTS reported in the 2014 ACR USPS CRA Model Public B Cost Matrix less [6].

[6]: Inframarginal Costs calculated following McBride's methodology applied to 2014.

[7]: Attributable cost reported in the 2014 ACR USPS CRA Model Public B Cost Matrix.

[8]: (Weighted Volume in 2014) x (Slope coefficient of regression).

[9]: [5] - [8].

[10]: [7] + [8].

Note that in 11 of the 17 components in which weighted volume took a negative coefficient, the implied variable costs that result when the stated and "hidden" costs are added together are negative, and that combined, the implied variable costs for these components are strongly negative. Dr. Neels does not believe it is plausible that

variable costs should be negative in components in which total costs are positive.

Furthermore, for seven of these components, the negative “hidden variable costs” outweigh the total cost of the segment, an even less plausible result.

In any comparison between the positive hidden variable costs identified in Proposal Two and the negative hidden variable costs in column [8] of Table 3 (*i.e.*, the supposed “hidden fixed costs”), the components for which the estimated coefficient is insignificant should be ignored, just as the components with insignificant positive coefficients were ignored in Dr. Neels’ calculations for UPS Proposal Two. Of the remaining eight components with negative and significant slope coefficients, four components, accounting for \$636 million in hidden variable costs, have the implausible result described above that total implied attributable costs are negative.³⁹ These should also be ignored.

This leaves four components with potentially overstated variable costs, totaling approximately \$1.2 billion. The bulk of these potentially overstated variable costs pertain to component 204 (“Workers’ Comp Current Year”), which is currently distributed

³⁹ The two components that yield the highest amount of negative hidden variable costs in Table 3 are component 203 (“Annuitant Health Benefits – Pre-funded (Prior)”) and component 205 (“Workers’ Comp Prior Year”). In both components, the totals in column [8] of Table 3 are based on insignificant coefficients, and the implied costing yields an implausible result, wherein implied attributable costs are negative. Both costs are already entirely fixed, and with good reason. In the case of annuitant health benefits, “P.L. 109-435 established a ten-year schedule of Postal Service prefunding payments” that have dictated the variation in this component over time. See United States Postal Service, FY 2014 Annual Report at 60 (Form 10-K) (Dec. 5, 2014). Similarly, “[c]hanges in the workers’ compensation liability are attributable to the combined impact of changes in the discount and inflation rates, routine changes in actuarial estimation, new compensation and medical cases, and the progression of existing cases.” *Id.* at 62. This is especially true with respect to component 205, which pertains to funding existing workers’ comp claims from previous years. Dr. Neels does not believe it is plausible that any portion of either component is related (positively or negatively) to current year volumes.

according to a distribution key that is based on the cost attribution of several other components. It is apparent that the workers' compensation costs relating to incidents in the current year are likely to be an increasing function of the size of the Postal Service workforce, and the number of hours worked, which will in turn be a function of the volume and weight of mail and parcels being moved. Moreover, it is likely that non-volume related factors such as changes in health care costs and changes in interest rates account for much of the remaining variation over time in the size of this component. These considerations suggests that while there may be a fixed portion of the costs in this component, the variable portion of the costs in this component is clearly substantial.

Accordingly, Dr. Neels believes that the fixed-variable split for this component under current costing procedures (approximately 45% fixed and 55% variable) is far more plausible than that suggested by the split that would result after adjusting for the supposedly "hidden fixed costs" (approximately 96% fixed and 4% variable). Nonetheless, Dr. Neels agrees that it may make sense for the Commission to reexamine the costing procedures for this component, in addition to those components with positive coefficients identified in Table 13 of Dr. Neels' report.

- c. **The hidden variable costs for each market dominant product, akin to the breakdown provided for competitive products in Table 15 of the Report of Dr. Kevin Neels.**

The requested information is shown in Table 4 below.

Table 4: Proposal Two Cost Impact w/ Product Detail (2014 \$ Millions)

Mail Class	Attributable Cost		Hidden Variable Allocation	Hidden Variable Allocation - Last Mile	Proposal Two	% of Current Costs
	[1]	[2]	[3]	[4]	[5]	[6]
Market Dominant Products						
Single-Piece Letters	5,710	526	61	6,236	109%	
Single-Piece Postcards	266	27	4	293	110%	
Total Single-Piece Letters and Cards	5,977	552	65	6,529	109%	
Presort Letters	4,560	429	61	4,989	109%	
Presort Cards	184	18	3	202	110%	
Total Presort Letters and Cards	4,744	448	64	5,192	109%	
Flats	1,566	140	18	1,706	109%	
Parcels	543	49	5	591	109%	
First-Class NSAs	13	-	-	13	100%	
Outbound Single-Piece First-Class Mail Int'l	188	-	-	188	100%	
Inbound Single-Piece First-Class Mail Int'l	249	-	-	249	100%	
Total First-Class	13,280	1,189	152	14,469	109%	
High Density and Saturation Letters	370	42	8	412	111%	
High Density and Saturation Flats and Parcels	881	103	28	984	112%	
Every Door Direct Mail Retail	39	4	1	44	111%	
Carrier Route	1,686	190	45	1,876	111%	
Letters	4,895	488	71	5,383	110%	
Flats	2,497	246	43	2,744	110%	
Parcels	103	9	1	112	109%	
Standard Mail NSAs	63	-	-	63	100%	
Total Standard Mail	10,534	1,083	197	11,617	110%	
In County	86	10	2	96	112%	
Outside County	2,048	199	34	2,248	110%	
Total Periodicals	2,134	209	37	2,344	110%	
Alaska Bypass	16	-	-	16	100%	
Inbound Surface Parcel Post (at UPU Rates)	13	-	-	13	100%	
Bound Printed Matter Flats	134	12	1	146	109%	
Bound Printed Matter Parcels	251	23	3	274	109%	
Media and Library Mail	328	25	2	353	108%	
Total Package Services	743	59	7	802	108%	
International Negotiated Service Agreements	143	-	-	143	100%	
Free Mail - blind, handicapped & servicemen	40	4	0	43	109%	
Total Market Dominant Mail	26,874	2,544	393	29,418	109%	
Total Domestic Ancillary Services	905	-	-	905	100%	
Total International Ancillary Services	13	-	-	13	100%	
Total Special Services	413	-	-	413	100%	
Total Market Dominant Services	1,331	105	20	1,436	108%	
Total Market Dominant Mail and Services	28,205	2,649	413	30,854	109%	
Competitive Products						
Total Priority Mail Express	366	30	2	395	108%	
Total First-Class Package Service	1,155	97	13	1,252	108%	
Total Ground	2,472	217	33	2,689	109%	
Total Priority Mail	5,234	380	24	5,615	107%	
Total Competitive International	1,385	-	-	1,385	100%	
Total Domestic Competitive Services	359	1	0	359	100%	
Total Competitive Mail and Services	10,970	725	72	11,695	107%	
TOTAL ATTRIBUTABLE COSTS	39,175	3,374	485	42,549	109%	
OTHER COSTS	34,187	(3,374)	(485)	30,813	90%	
TOTAL COSTS	73,362			73,362		

Notes and Sources:

[1]: Mail Classes reported in the FY14 Public Cost and Revenue Analysis (PCRA).

[2]: Attributable Costs as reported in the FY14 PCRA.

[3]: Additional attributable costs from Hidden Variable costs allocated in Proposal Two. Hidden Variable costs are first allocated to Mail Classes in the CRA Cost Matrix B. The Hidden Variable Costs allocated to the "U.S. Postal Service" mail class in the CRA Cost Matrix B have been distributed between CRA Cost Matrix B "Total Market Dominant" mail classes according to their Hidden Variable Cost Allocations. The CRA Cost Matrix B mail classes were then matched (when possible) to mail classes reported in the PCRA. The mail classes and associated costs in the Cost Matrix B do not directly match what is reported in the PCRA. Thus the additional costs for both Proposals here are estimates.

[4]: A subset of the costs in [3] for components in Cost Segments 6, 7, and 10.

[5]: [2] + [3].

[6]: [5] / [2].

Respectfully submitted,

UNITED PARCEL SERVICE, INC.,

By: /s/ Steig D. Olson
Steig D. Olson
Quinn Emanuel Urquhart & Sullivan, LLP
51 Madison Ave., 22nd Floor
New York, NY 10010
(212) 849-7152
steigolson@quinnemanuel.com

Attorney for UPS